

Retirement Provision for an Ageing Population

GFIA opinion paper on ageing populations as a global risk

Summary

The world is experiencing an unprecedented demographic transformation brought about by declining birth rates and rising life expectancy. Together, these trends are leading to a dramatic decline in the ratio of workers to retirees in many markets and increasing aged populations even in “young” nations. Furthermore, economic volatility is reducing the willingness of employers to maintain traditional workplace pension arrangements.

Without effective policy responses, many countries will find it increasingly difficult to maintain an adequate living standard for retirees without putting an unacceptable burden on workers. Facilitating individuals to pre-fund their retirement benefits would avoid inappropriately shifting the costs of ageing between generations. To meet this challenge, governments around the world should aim to a) increase sustainability within their retirement systems, and b) diversify such systems by providing complementary retirement savings and utilising supplementary retirement income mechanisms beyond the provisions of mandatory state pensions.

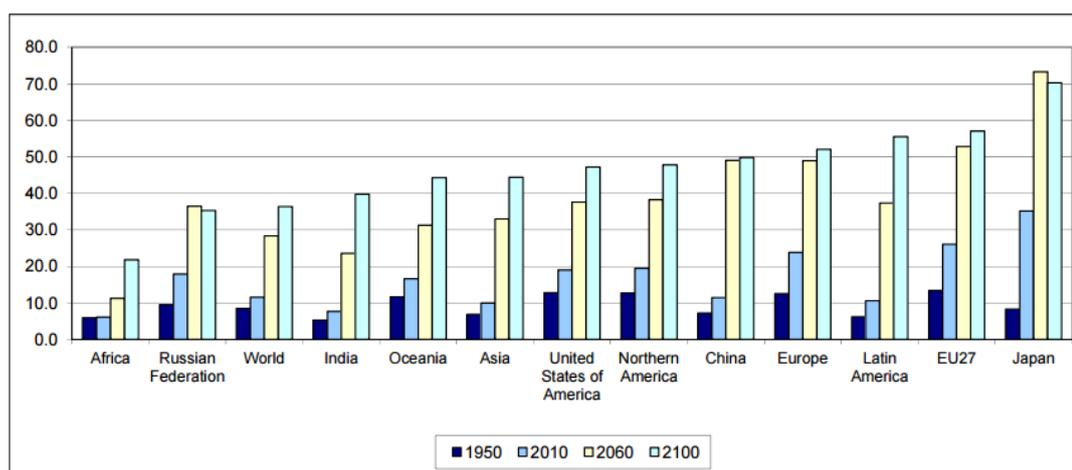
Insurers are the main providers of long-term savings and pensions products, and policymakers should ensure that prudential regulations for insurers do not undermine this critical function. This means that the capital required for life insurance products should reflect prudent consumer protection objectives, but that investments in long-term assets (e.g., infrastructure) should not be discouraged by regulation. Policy measures that aim to protect retirement savers should be balanced and proportionate with regard to the characteristics of the products to avoid undermining the availability of retirement savings products. Only if an environment exists that provides policy stability and ensures flexibility to innovate, can insurers support the design of new products that meet consumers’ needs and ambitions.

The Challenge

It is difficult to overstate the scope of “global ageing”, as the demographic transformation is popularly known. To illustrate its dimensions, we refer to a recent article from the Organisation for Economic Co-operation and Development (OECD) “insights” series¹:

That population is ageing across the world is well known. As fertility rates drop and life expectancy improves, a bigger share of the population is greying. At least one in four people will be aged over 65 by 2050 in about two-thirds of OECD countries. The share of those aged over 80 years will more than double, from 4% in 2010 to 10% in 2050. In Japan, Spain and Germany, this trend will be even more pronounced, with the proportion of the over-80s expected to triple, rising from 5% to 15% in Spain and Germany, and from 6% to 16% in Japan. The speed of ageing will be even more dramatic in some emerging economies. China, for example has taken only 40 years to increase life expectancy from 40 to 70 years, something that took Germany 80 years.

Graph I.1.17: Old age dependency ratio (people aged 65 or above relative to the working-age population) by main geographic areas and selected countries (in percentage), 1950, 2010, 2060, 2100



Source: UN World Population Prospects: The 2012 Revision.

Global aging will have far-reaching economic and social consequences that threaten to put intense pressure on old-age support systems in all G-20 members, over time. Businesses will have to cope with a shortage of young workers, while an increasing number of elderly needs to be supported by families and governments. Fiscal budgets are likely to come under growing stress from rising retirement and health-care costs. Meanwhile, economic growth is likely to slow as working-age populations stagnate or contract, potentially eroding the financial base on which retirement income provision depends.

These developments will challenge the ability of many societies to balance the twin goals of retirement policy: adequacy and sustainability. In fact, in response to projections showing that the ageing of the population will put unsustainable upward pressure on public budgets in many mature markets, a growing number of governments have already enacted reforms that significantly reduce the future

¹ See *European Commission 2015 – The 2015 Ageing Report. Economic and budgetary projections for the 28 EU Member States (2013-2060)*. *European Economy* 3/2015

generosity of state retirement income provision. Yet even if those reforms are successfully implemented and labour market participation could be significantly increased, increased longevity will still create costs which are historically unprecedented.

If not recognized and addressed, these unprecedented factors have the potential to affect all aspects of national and also international policies. Increasing longevity and the inevitable consequence, of the need for increased funding of retirement security, is thus an issue with global implications which should be considered by the G-20.

Two additional factors complicate the challenge. The first is the high level of public indebtedness, which further constrains the fiscal room that governments have to accommodate rising retirement and ageing costs. Globally, public debt has significantly increased in the past decade. For instance, the euro area average public debt-to-GDP ratio was 65% in 2007. In 2014 it stood at 92%.

The second factor is the record-low interest rate environment in many large economies, which makes it more difficult to finance private pensions that can help fill the retirement income gap that is emerging as state pension systems retrench. By way of illustration, the long-term risk-free interest rate in Germany was in the order of 7% in 1994, 4% in 2004, and below 1% in 2014. The US Federal Reserve has been in an extraordinary period of near-zero interest rate on Treasury bills since 2008. With measures such as quantitative easing, it seems likely that interest rates in these jurisdictions will remain low for a long time, compounding the ageing population challenge.

This combination of factors (rapidly ageing populations, high public debt burdens, and record-low interest rates) is completely unprecedented. So too is the resulting long-term erosion in the retirement income prospects of today's working generations. In some countries, for example, the decline of defined benefit schemes and the switch to defined contribution schemes may also be driving, in the longer-term, lower pension pot values in the future. The lack of understanding among consumers on what are the best pension products for them to utilise, that best suit their needs (such as annuities versus drawdowns), is also contributing to the challenges to achieving adequacy and sustainability in retirement.

The declining generosity of state retirement income provision might be less of a concern if people were saving enough for retirement or had access to a workplace/occupational pension. Unfortunately, there is a significant amount of research that suggests otherwise. Meanwhile, rising life expectancy puts people at a growing risk of outliving whatever personal retirement savings they do have.

Policy Responses

As these trends unfold, GFIA believes that the success of countries at ensuring retirement security and sharing the costs of ageing between generations will increasingly depend on their success at building strong complementary retirement savings systems. From the insurers' experiences as risk-managers with a long-term perspective, we offer the following arguments about the importance of strengthening multi-pillar pension systems and incentivising retirement savings:

A. Multi-pillar pension systems

- One of the strongest tools that governments have at their disposal to confront global aging is a well-designed pension system that includes different parts, often called pillars. Such a system diversifies the risks described above, as the factors affecting different pillars are not fully correlated.
- In order for multi-pillar systems to be successful, pension pillars must complement each other. If this is ensured, the overall effectiveness of the system is increased, because it is not overly exposed to any single external risk factor and the different elements allow achieving several goals simultaneously: poverty reduction, sustainable income replacement, flexibility, affordability and long-term savings. For most state-run pensions, sustainability depends on a high ratio of taxpaying or contributing workers to retired beneficiaries. Over-reliance on this pillar makes a society vulnerable to poor labour ratios and ageing demographics. Private sector pensions serve a complementary function to state-pension schemes, making the overall system more robust and resilient.

B. Incentives for long-term retirement savings

- To increase the effectiveness of a multi-pillar pension system, participation in the complementary tier should be encouraged as part of an approach that recognises the complexity of an issue, which requires a multi-pronged solution from the state, regulators, and the industry, as well as from individuals themselves. To this end, governments can use certain policy tools (e.g. enrolment rules, tax incentives, state contribution for pensions, education) that are recognized to add incentives for long-term retirement savings.
- Different types of enrolment rules help make pension participation possible for all segments of society. Auto-enrolment, for example, can improve savings rates, particularly amongst those who may not be saving for retirement otherwise, contributing to a positive outcome.² Quasi-mandatory enrolment (e.g., some types of employer-sponsored plans) and voluntary pension products can also help to maximise the availability of long-term savings products to all segments of the population.
- Tax incentives and state contribution, when well designed and communicated properly, can incentivise consumers to save for retirement. They can also disincentivise exiting the workforce early. In this regard it is absolutely crucial that the value of these incentives should be stable over time, as pensions provision is a long-term business. Governments should resist the temptation to roll back incentive schemes when faced with short-term public finance challenges.
- Financial literacy campaigns are an important tool that can educate citizens and help them make prudent financial decisions.

² <http://www.thepensionsregulator.gov.uk/docs/automatic-enrolment-declaration-of-compliance-monthly-report.pdf>:
<http://www.thepensionsregulator.gov.uk/docs/pensions-reform-resource-the-different-types-of-worker.pdf>

Insurers' Role

GFIA believes it is essential that governments around the world take serious steps to ensure their citizens enjoy adequate retirement income by stimulating the availability and uptake of pension products beyond any mandatory schemes put in place by the government. Insurers have an integral role to play in this effort, as they are major providers of occupational, workplace and personal pensions as well as life insurance. One distinguishing feature of insurers is that they can provide protection for very different life risks: provision for dependants in case that the saver dies prematurely, protection against outliving the assets (longevity risk) and morbidity risk coverage. Risks can be covered both in the accumulation and – by annuities and drawdown products – in the pay-out phase. Insurers can also offer a wide range of pension products in line with the varying market traditions and practices of different countries.

The nature of the insurance business model, i.e. long-term coverage of policyholders' risk in exchange for premiums that are paid upfront, enables insurers to match liabilities towards policyholders with long-term and stable assets. These include investments in infrastructure and SMEs, which are vital for stable economic growth. The advantages for policyholders include:

- Sustainable lifetime income.
- Less volatile long-term returns due to pooling investments.
- Higher yields available from long-term and illiquid investments.
- Access to professional investment expertise and information services.
- Lower direct and indirect costs due to economies of scale.
- Access to asset classes in which they would otherwise not be able to invest easily (such as private placements and “big ticket” investments).

The provision of long-term funding is also beneficial to the economy. In their role as long-term investors, insurers:

- Help governments, corporations, and individuals meet their funding needs via the wide range of assets that they hold, including equity-type assets, government and corporate debt, and securitisations and covered bonds (which indirectly help funding of SMEs or individuals' mortgages).
- Provide stability during periods of market turmoil. Insurers' buying and selling of assets is inclined to be counter-cyclical, even in periods of market stress with significant drops in market prices when other actors are keen to dispose of assets.

To achieve these outcomes, insurers need a well-designed prudential framework that ensures security for policyholders and allows insurers to exercise their role as providers of voluntary retirement savings products. This means that the capital required for life insurance products should reflect prudent consumer protection objectives, and that investments in long-term and/or illiquid assets (e.g., infrastructure) should not be discouraged.

Consumer protection is paramount to ensure trust in providers of complementary pensions. But regulation should not undermine the ability of insurers and distributors to offer retirement savings to workers and consumers. Policy measures that aim to protect retirement savers should be balanced and proportionate with regard to the characteristics of pension products and the choices that people face.

Conclusion: Threats and Opportunities

Failure to respond to the challenges posed by global ageing could have serious consequences for national economies in many G-20 markets, which would slow down global growth and prosperity at both a national and global level. The natural consequences of increasing longevity, larger elderly population and longer retirements, are creating new policy challenges for the vast majority of governments. Recognizing that this is a global issue and developing global strategies to manage a soft transition should be considered as a priority for G-20 leaders' attention.

As demographic pressures mount, many countries have to balance the needs of future retirees for an adequate living standard and a level of contributions that does not overburden future workers. In the end, pension policy has to ensure that it will not be the most economically vulnerable members of society who suffer, as a growing number of workers reach old age without adequate pensions, personal savings, or the support of their extended families.

With appropriate reforms and a healthy, competitive market for complementary retirement savings solutions, policymakers can achieve a rebalancing of their pension systems, which will not only forestall the looming retirement crisis, but can also provide a host of genuine benefits to the national economies. It is essential that there be an appropriate prudential and consumer protection framework in place that allows insurers to serve customers in this way.

Insurers stand ready to work with policymakers to help ensure that the broadest possible cross-section of the public has access to a well designed, diversified and robust pension system.

About GFIA

Through its 41 member associations, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 60 countries. These companies account for around 87% of total insurance premiums worldwide. The GFIA is incorporated in Switzerland and its secretariat is based in Brussels.